



# UNDER SCRUTINY

Aggressive federal probes  
put GCs in jeopardy

by MELISSA MALESKE AND MARY SWANTON

ROBERT GRAHAM'S STORY IS AN IN-HOUSE ATTORNEY'S worst nightmare, though it began auspiciously enough. Two years after graduating from Boston University law school, Graham was manager of the Civil Division of the Delaware Department of Justice. After a stint as campaign manager for a congressman, he became a member in a Wilmington law firm. In 1986 he moved to a lofty in-house position, becoming senior vice president and assistant general counsel at General Re Corp., one of the world's largest re-insurers.

But his professional progress came to an abrupt halt in 2005 when he was indicted for his alleged role in a scheme to inflate the stock price of one of General Re's major customers. Graham resigned shortly before the indictment and hasn't worked since. Now 59-year-old Graham faces the possibility of spending the rest of his life in prison after a jury convicted him in February of 16 counts involving conspiracy, securities fraud, mail fraud and making false statements to the SEC.

"He's devastated by this whole ordeal," says his attorney Alan Vinegrad, a partner at Covington & Burling, who plans to appeal the conviction. "You [in-house counsel] have to be extremely careful lest you find yourself in the kind of situation Rob Graham finds himself in now."

Graham's plight exemplifies what has become an all-too-common story in the in-house bar. In the past five years, at least 34 in-house attorneys have been convicted of, pleaded



guilty to or settled civil or criminal charges brought by the SEC or the DOJ, and another 12 have been charged and have cases pending (see “Adding It Up,” p. 52). While there is a concentration in the high-tech sector, which served as center stage to the options backdating scandal, the defendants represent a wide range of industries and company sizes.

“It’s troubling how many inside counsel have gotten themselves into legal difficulty,” says Greg Wallance, a partner at Kay Scholer and a former federal prosecutor. “It’s a fairly broad array from a variety of industries and a variety of conduct, from filing false income tax returns to backdating options to filing false financial statements.”

## Converging Forces

The escalation of enforcement actions against in-house attorneys results from several separate factors that all came into play in the early years of this decade, according to Wallance and other white-collar crime specialists. First, the Bush administration, taken to task after the WorldCom and Enron scandals, put a high priority on sniffing out corporate crimes. Most notably, President Bush established the Corporate Fraud Task Force in 2002, bringing together the resources of the DOJ, the SEC and other federal agencies to restore investor confidence in corporate America. The head of the task force and the associate director of the SEC’s division of enforcement both insist their focus is corporate corruption generally, not general counsel specifically (see “Compliance Cops,” p. 56, and “Fraud Fighters,” p. 58). But in-house counsel who have been targets of the two agencies and their attorneys see it differently.

“Over the past few years, both the DOJ and the SEC have definitely been more active in going after lawyers,” Vinegrad says. “They view in-house counsel as so-called gatekeepers who are supposed to prevent bad things from happening, and when bad things happen, they are much more focused on going after the lawyers who were there.”

As the government stepped up enforcement, the 2003 Thompson Memo encouraged prosecutors to pressure companies to waive attorney-client privilege.

“Before that, what an in-house attorney would do was something that the government could not see,” says Timothy Harkness, former federal prosecutor who is now a partner at Kramer Levin Naftalis & Frankel. “Then it became common practice for government investigators in their first conversation about a corporate scandal to ask the company to waive attorney-client privilege. As a result, GCs had their conduct scrutinized as it had not been before.”

Add to the mix Sarbanes-Oxley, which vastly complicated the reporting requirements of public companies. Many in-house counsel moved out of the confines of the legal department to take on bigger business roles, where their traditional gatekeeper duties became muddled.

“Where there is a lot of pressure to achieve double-digit growth, that creates a lot of pressure on GCs to go along with practices that may present legal risks, not only for the company but for the inside counsel personally,” Wallance says. “A lot of them find it difficult to take a strong stand and say to the business people, ‘You can’t do that.’”

Others simply found themselves in over their heads. The problem was particularly acute for lawyers in smaller public companies who lacked the resources to hire outside experts in securities law, says Daniel Skerritt, a partner at Tonkon Torp. Skerritt represented Jack Isselmann, former general counsel in the one-man legal department of Electro Scientific Industries, who settled with the SEC in 2004 (see “Targeted and Fined,” p. 55).

“You can imagine being the guy who’s looked to for answers on human resources questions that turn legal and contract interpretations and then has to deal with the accountants [on complex securities issues],” Skerritt says.

## Gray Areas

While some of the cases of indicted GCs involved intentional and knowing misconduct, many of the issues were not black and white or at least were easily rationalized. In Silicon Valley, the problem of attracting top talent to companies not yet generating profits led to compensation structures built largely on stock options. When those options could be made more valuable by changing dates on the paperwork, many general counsel apparently thought it wasn’t a big problem because no one was getting hurt.

“It’s easy when the issue is obvious,” Wallance says. “Most of these problems arise when it is a somewhat closer legal call. The question usually is not whether we are going to steal money from the company but something more ambiguous: How much risk do you want to tolerate? How close to the line do you want to get?”

How those questions are answered varies with the personality of the GC and how he or she views the job, Wallance says. Some are more risk averse and opt for protecting the company from legal risk over increasing profits. Others think their job is to find a legal argument to justify whatever the business people want to do. Some find creative ways to meet the business objectives within the law; others aren’t as adept at finding alternatives.



“You have to look at [the indicted GCs] on a case-by-case basis,” Wallance says. “Most involve a combination of personality, judgment and lack of creativity, and business pressures that create these situations.”

Both defense attorneys and prosecutors acknowledge that it takes a strong personality to say ‘no’ to most CEOs. For young GCs, who may not have the full confidence of the CEO, the challenge can be particularly acute.

“Sometimes when you have younger individuals in the position of general counsel and you have type-A executives running companies, the executives may not give them the authority to do their job appropriately,” Skerritt says.

## Chilling Effect

While SEC and DOJ prosecutors insist that general counsel who act in good faith have nothing to fear, the specter of government investigations is generating more internal investigations and potentially more cautious GCs.

“It’s like doctors who have become victims of escalated and excessive malpractice suits,” says Mark Belnick, former general counsel of Tyco Inc. who was acquitted of fraud charges in 2004 (see “Free and Clear,” p. 54). “A doctor may order 20 tests now. Do we want general counsel to start practicing defensive law? They probably already have, not because they are cowardly or involved with anything wrong, but because nobody wants to raise his hand and say, ‘I’ll be the martyr to see if I can change it all.’”

Belnick says the atmosphere has created “a lawyer’s full employment act for outside counsel,” and Harkness has noticed in-house attorneys calling him in more often to “kick the tires on transactions” rather than signing off on them themselves. He also sees more careful recordkeeping.

“I see in-house lawyers spending more time articulating a rationale for what the company was doing so people can look back and understand why it was done,” Harkness says. For one of his clients, such documentation quickly scuttled an SEC inquiry.

Perhaps the most damaging potential impact of the current prosecutorial focus on in-house counsel would be discouraging talented lawyers from going in-house. While recruiters report that in-house jobs are still in demand, some observers fear that the best and the brightest lawyers may stay away from corporate careers out of self-defense.

“If the government consistently paints a target on the back of the general counsel of companies it looks at, exactly the kind of people the government should want to be in that position—smart, capable and honest people who can give good and

forthright legal advice—are not going to take the job,” Belnick says.

One solution is to give the general counsel more open access to the board of directors, either reporting directly to the board or at least having access to inform the board if the CEO is running amok.

“We have to find a way to lessen GCs’ dependence on the CEO,” Wallance says. “If the general counsel’s job prospects, power within the company and rewards come from the CEO who holds all the goodies, there is a risk that this will have a distorting effect on the GC’s willingness to say ‘no.’”

But regardless of reporting structure, for most GCs the new reality is that the stakes of the game have gone way up, says Vinegrad, whose client Robert Graham was awaiting a sentence of up to 210 years in jail at press time.

“Being the general counsel of any company, particularly a public company, is just a much higher-risk enterprise now than it ever was,” Vinegrad says.

To read the list of in-house counsel who have faced SEC and/or DOJ probes, visit [InsideCounsel.com](http://InsideCounsel.com).



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## Adding It Up

In the past five years, the DOJ and/or the SEC have taken action against more than 50 in-house counsel, according to a study by the American Bar Association’s Section of Litigation and data from the SEC.

24

**In-house counsel settled with the government or pleaded guilty**

10

**In-house counsel found guilty**

5

**In-house counsel acquitted or charges dismissed**

12

**In-house counsel charged with cases pending**

# Free and Clear

Mark Belnick speaks out on the perils facing general counsel

Mark Belnick belongs to a very select club—indicted general counsel who beat the rap. In fact, he is one of just three who have been acquitted in the past five years, while others made plea deals or took a chance at trial and lost.

Belnick's exoneration is even more noteworthy because his former boss, Tyco's flamboyant ex-CEO Dennis Kozlowski, was convicted of grand larceny and fraud and sentenced to prison.

Seemingly caught up in the scandal, Belnick faced a possible 25-year prison term if convicted on grand larceny charges brought by the Manhattan District Attorney's office, which accused him of accepting from Tyco more than \$30 million in undisclosed loans and bonuses not approved by the company's board. After a 10-week trial, a jury acquitted him in 2004, and in 2006 Belnick settled charges with the SEC without admitting or denying them, paying a \$100,000 fine and agreeing not to serve as a company officer or director for five years.

*"If a lawyer feels he needs a lawyer in order to do his job as a lawyer, something's gone wrong."*

Given his current views on the state of today's corporate counsel, it's likely that the last provision of the settlement doesn't bother Belnick, who now practices at his own firm in New York. He portrays the in-house counsel role as one fraught with paranoia, landmines, and rash investigations and accusations.

"Nobody has immunity because they're a lawyer," Belnick says. "On the other hand, the aggressive focus on general counsel has almost become the normal consequence of an investigation of the corporation."

Behind this atmosphere are good intentions, he believes, but instead of doing good they are complicating the role of general counsel. Key among Belnick's misgivings about this new environment is the growing frequency of internal company investigations. Once reserved for only the most grave situations, now they have become "almost a norm," Belnick says. This can be a good thing—directors can catch corporate misconduct before it becomes widespread. But it also means issues that once could have been handled within the com-

pany are now increasingly being investigated by outside counsel.

And given the government's recent focus on general counsel, those outside counsel now tend to hone in on the general counsel and exclude him or her from participating in investigations—a disservice since general counsel, already tuned in to the legal goings-on of the company, can be key to unraveling internal situations and ensuring a speedy and efficient investigation, Belnick says.

The zeal often results in rushes to judgment, which usually lead to the investigating outside counsel recommending that the highest officers of a company be shown the door.

Belnick says the threat of becoming the target of an internal or external investigation has scared off bright and talented lawyers from going in-house.

"Painting the target on the back of general counsel certainly limits the pool of qualified people who are going to be willing to subject themselves to the kind of life in which they are constantly looking over their shoulders, worrying whether legal advice will be transformed by some overly aggressive prosecutor into involvement in some wrongdoing," he says.

The atmosphere of paranoia also is complicating the already thorny management-counsel relationship, he adds, and has even made some general counsel retain their own counsel—not to consult on issues outside their expertise but to consult on how they should behave to avoid getting in the middle of risky situations.

"Is that a desirable way for a general counsel to feel while they're performing their job? My submission is no," Belnick says. "If a lawyer feels he needs a lawyer in order to do his job as a lawyer, something's gone wrong."

The system is broken, Belnick contends, and should be fixed through small changes rather than the "battery of regulations" general counsel currently face. Referring to the Enron-era scandals, Tyco included, Belnick cites the old maxim that bad cases make bad law and points out that public outrage often leads to overreactions.

"A lawyer should be practicing law consistently with the highest ethical standards: with full performance of loyalty to his clients, no breach of fiduciary duties, complete conformity with the law," Belnick says. "But not as a potential defendant."



PHOTO COURTESY OF MARK BELNICK

# Targeted and Fined

SEC's first gatekeeper defendant moves on with his career.

It's been nearly four years since the SEC charged Jack Isselmann, then general counsel of Electro Scientific Industries (ESI), with "failure to fulfill his gatekeeper role." Needless to say, in the interim Isselmann has given some thought to that role.

"What the gatekeeper role requires, taking it to its extreme, is the ability to know what someone else is thinking and what their motives are for acting," Isselmann says. "I think that's a very difficult standard to put on any person in any context."

Isselmann was a one-man legal department at ESI when in 2002 the company's CFO James Dooley and Controller James Lorenz decided to eliminate \$1 million of benefits for its Asian employees, primarily located in Japan, and tack on the savings to ESI's bottom line.

When they asked Isselmann to check into the legality of cutting the benefits, outside counsel advised him that Japanese law prohibited ESI's actions, and he passed on that opinion to Dooley. It wasn't until 2003 that he found out Dooley, who by then had been promoted to CEO, had removed the company's future liability to pay the benefits from the company's balance sheet.

According to the September 2004 SEC complaint, Isselmann had several chances to spot the balance sheet inconsistency and bring it to the attention of ESI's audit committee and outside auditors. But the SEC never claimed that Isselmann actively participated in fraud; in fact, its complaint against Isselmann specifically points out that he "was not involved, present or consulted when the CFO and the Controller made the accounting decision."

The SEC charged Isselmann nonetheless, and the case was trumpeted in the press as the first gatekeeper charge of the post-SOX era—a time when SEC scrutiny and market upheaval were at a boiling point.

"To a certain degree, I think general counsel out there can take heart that my case just came along right in the middle of the government wanting to demonstrate very rigorous zero-tolerance type enforcement," Isselmann says. "Now we're back into a reactionary environment with the credit crisis, and I don't know if that will produce similar outcomes around this."

Adding to the perfect storm was the fact that Isselmann was the only in-house counsel in a company of about 500 employees.

"The gatekeeper function is particularly onerous for a

smaller public company, which does not have a built-out legal staff. Jack was pretty much a one-man shop," says Daniel Skerritt,

who represented Isselmann in the SEC proceedings and now practices alongside him at law firm Tonkon Torp. "For the GC in that position, it creates such a multifaceted requirement of expertise that it makes it a pretty tough assignment."

Isselmann agrees, pointing out that outside legal teams are rarely ensnared in the gatekeeper provisions. "It's the individual practitioner that gets singled out," he says, adding that in every context there must be more than one gatekeeper.

In addition, Isselmann was an uncommonly young general counsel—when he departed the company in 2003 he was 32. According to Skerritt, younger general counsel in particular may run into problems with management.

"By law, Sarbanes assigned a lot of responsibility, but unless you have the right understanding with your own management, you don't get the authority that you need to carry out that responsibility," Skerritt says.

And if an in-house counsel is unfairly targeted in an internal investigation or the regulators come knocking on your door, Isselmann recommends getting a good lawyer and preparing for a fight. The lawyer part worked out for Isselmann in more ways than one: He says he would have been lost without Skerritt by his side, as much for psychological support as legal advice. Isselmann made the difficult decision to settle rather than face years of legal proceedings. Thanks to an exonerating settlement agreement, Isselmann paid a \$50,000 fine but was able to successfully continue his legal career.

In fact, he made such a good impression on Skerritt and his firm that in 2006, when they were looking to expand the firm's federal lobbying practice, they turned to Isselmann. He became a partner in Tonkon Torp in January and has no plans to return to the in-house bar.

"The reality is, if you find yourself in one of these situations, you're probably going to have to raise a flag and quit," he says, equating the general counsel's job security to that of an NFL coach who could be shown the door after a few bad seasons.

Skerritt sees no end in sight, contending, "People better settle into it. The regulators are constantly under pressure to make sure they still hold the gatekeepers' feet to the fire."

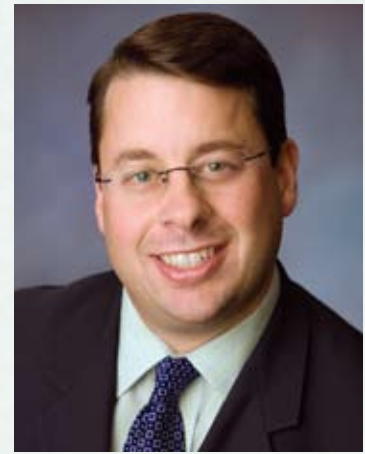


PHOTO COURTESY OF JACK ISSELMANN



# Compliance Cops

SEC's enforcers crack down on securities fraud

Chris Conte is an associate director of the SEC's Division of Enforcement, which has brought 125 actions against lawyers in the past five years, more than 40 of them in-house attorneys. *InsideCounsel* asked him to explain the division's recent rash of actions against in-house attorneys.

*InsideCounsel: Why has the SEC brought so many cases against in-house counsel in recent years?*

Conte: If you break down the numbers, there have been more actions against lawyers in the past five years than, perhaps, any other five-year period. While I don't want to say [enforcement] has been stepped up through any specific targeting, obviously the past few years have offered fairly unprecedented incidences of fraud and misbehavior, and to some extent we respond to what we see. Putting aside the large-scale frauds that occurred in the early periods of this decade and the options scandals, I really don't have a good explanation [for the increase]. It may simply be a function of lawyer conduct being more involved in the kinds of cases we are seeing now.

*Is it fair to say the SEC has increased its scrutiny of in-house attorneys?*

There has always been a focus on what we describe as gatekeepers. We certainly view in-house lawyers, who are in a position to advise their companies and clients on disclosure issues and compliance with federal securities laws, as people at the front line of trying to ensure that the law is complied with. Since Sarbanes-Oxley, it's fair to say that we felt Congress had

specifically identified lawyers as crucial participants in the protection of the markets. But nothing has changed in terms of the standards that we apply in evaluating lawyer conduct. We don't bring cases where lawyers have rendered incorrect legal advice or even given negligent legal advice. We don't want to chill lawyers who are acting in good faith from giving advice to their company or clients.

*How would you respond to in-house counsel who feel they are operating with a target on their back?*

I certainly would not say that the Division of Enforcement or the Commission is targeting lawyers. If I was an in-house lawyer, however, and I was looking at what has happened—cases being brought by the SEC and Justice Department, civil/criminal liability—clearly, a lot of attention has been paid. So I can understand, but they should have no concern or worry if they act in good faith and attempt to render sound and informed legal advice.

*Many in the in-house community are concerned about maintaining attorney-client privilege in the course of an SEC investigation.*

I recognize that the whole issue of privilege is one where there has been a lot of expressions of concern, but the SEC has always felt we were in the right place. We wouldn't want to make companies ever feel that they will be penalized in any way for not waiving privilege. It will be given some weight in terms of cooperation, but no one will be penalized, and nobody from the SEC should ever make an explicit

demand for a company to waive privilege or suggest that it will be penalized for not waiving privilege.

*What should in-house counsel be aware of if their company is conducting an internal investigation into possible misconduct?*

From the SEC's perspective, when companies learn of potential misconduct, companies have to evaluate that. They may conclude it's unnecessary to report it to us, and that may be true. But they have to demonstrate that they addressed it and looked at it and considered it, because if we do find out about something, and the company didn't do anything, they're in a more difficult beginning place with us.

*What is your message for in-house counsel concerned about SEC scrutiny?*

In-house counsel must be vigilant and courageous at times because their obligations are to the company and its shareholders. They have to be aware of what they know, what they don't and what the company is attempting to do. They have to ensure disclosures are not materially false and misleading. They have to be willing to not waver if the advice they're going to give is unwelcome. Management may come to them with ideas that may be completely consistent with those interests. When it isn't, general counsel have to be willing to stand up and give that advice. The lawyers should really have little to fear from the SEC as long as they keep the interests of the company and its shareholders first and foremost and are prepared to act in informed good faith.

# Fraud Fighters

DOJ task force tackles corporate corruption



President Bush created the inter-agency Corporate Fraud Task Force in 2002 in the wake of the Enron and WorldCom debacles. Its mission: “To protect the markets, protect shareholders and protect the public from future Enrons and WorldComs,” says Gil Soffer, associate deputy attorney general who oversees the task force. The task force has won more than 1,200 corporate fraud convictions as of July 2007, including 23 in-house counsel, with prosecutorial tactics disparaged by some as overzealous. *InsideCounsel* asked Soffer to clear the air.

*InsideCounsel: Is the perception of increased DOJ focus on in-house counsel accurate?*

Soffer: The Department has not increased our focus on in-house counsel specifically, but there has been an increase of all corporate fraud investigations and prosecutions. So to the extent you’re seeing an increase in prosecutions or investigations of in-house counsel, it’s really a function of our intensive focus on corporate fraud in general. Clearly, in the past 10 years we’ve seen far more activity in the world of corporate fraud, and I think it really hit its peak with Enron and WorldCom. What we did in the wake of those scandals was to say, this is a problem that is incredibly grave, and we have to marshal our forces against it.

*What is the role of the general counsel in preventing corporate fraud?*

In our view, the general counsel’s role in this context is to provide advice to the corporation about whether its actions, proposed and ongoing,

comport with applicable law and regulations. The in-house counsel is specially suited to that task, and it’s his or her job to advise the company about whether [its actions] are lawful.

*Is this role at odds with reporting lines, wherein the general counsel reports to the CEO, who is charged with growing profits?*

It’s not that in-house counsel are going to keep the company from recognizing revenue or generating profits—I think the opposite is true. If they keep a company advised about what a law requires, at the end of the day the company won’t be facing investigations or charges, and ultimately that will be more cost-effective.

*Do you think the rash of prosecutions of GCs is having a chilling effect on the way in-house counsel do their jobs, making them reluctant to give legal opinions when they should?*

I would hope the opposite is true. Let’s be clear, the vast majority of GCs are ethical and careful attorneys who serve their corporations well. I would think the effect of heightened scrutiny in the past 10 years on corporate misconduct would lead GCs to give the advice they feel they must give and to ensure the corporations are getting their best advice on what is lawful.

*Besides the general counsel, are there other positions within corporations where a person can be held responsible for misconduct even if he or she hadn’t directly participated in it?*

If GCs are doing the job that most of them do and do very well, and they

stay within the bounds of the law, they need have no fear. If you look at the kinds of prosecutions that have been brought that have involved in-house counsel, you see cases in which in-house counsel hid information from auditors or were involved in the preparation of false documents or lied to investigators—acts that are criminal no matter who commits them. I don’t think general counsel are held to a standard that’s different from other corporate officials in that regard. If the elements of the crime are there, then we prosecute; if they’re not, then we don’t.

*Do you buy the notion that some of these prosecuted lawyers were merely pulled into these situations by virtue of their position?*

I haven’t seen any evidence that the Department has ever prosecuted an in-house lawyer in a corporate fraud case where that lawyer did nothing criminal.

*What’s on the DOJ’s front burner? Should we expect the increase in indicted GCs to continue growing?*

The Department is seeing a steady and varied diet of criminal cases. There are always fraud cases of every kind and misstatements in public disclosures. It’s hard for me to predict whether [indictments will increase]. If the number of prosecuted in-house counsel grows, I think it will grow as a function of corporate prosecutions growing generally. We hope these prosecutions will have the desired deterrent effect, and we’ll see fewer prosecutions someday because we’ll see fewer instances of corporate fraud. n